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IN THE

Supreme Court of the United States

October Term, 1951.

No. .....

GEORGE HERBERGER and MABEL HERBERGER,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit entered in the above-entitled matter on March 7, 1952.

Opinions Below.

The memorandum findings of fact and opinion of the Tax Court is reported at 9 T. C. M. 546. The opinion of the Court of Appeals is reported in 195 F. 2d 293.

Jurisdiction.

The judgment of the Court of Appeals was entered on March 7, 1952. [R. 111.] The jurisdiction of this Court is invoked under I. R. C., Section 1141(a), and 28 U. S. C., Section 1254(1).

Questions Presented.

The questions presented in this proceeding are as follows:

1. Whether under the facts and the law of California the transaction between petitioner George Herberger and one Harmel in 1944 was (a) an immediate sale, on credit, of Herberger's entire stock of pickles, or (b) a transaction in which, as each payment was made, there was a sale for cash of an equivalent quantity of pickles at the price agreed upon.

2. Whether petitioners' income was, solely by virtue of certain Treasury regulations, not clearly reflected on a cash basis.

Statutes and Regulations Involved.

The text of the statutes and regulations involved herein are contained in the Appendix, *infra.*

Statement of the Case.

This proceeding involves the federal income tax liability of petitioners for the years 1943 and 1944. Petitioners are husband and wife. They resided in California during the taxable years. The income here involved was all community income. [R. 76.]

Petitioner George Herberger was engaged in the taxable years in the business of processing and selling pickles. [R. 76.] He carried on the processing with no more than one or two temporary helpers and had a trucker attend to deliveries and make collection on delivery. [R. 77.]

Herberger bought his year's supply of cucumbers in July. They were placed in vats and salt was added. The curing in salt required 90 to 120 days. Thereafter quan-

tities of the pickles were placed in smaller tanks and processed for about three days. Herberger could process a total of 42 barrels a week. Herberger sold his pickles in barrels, or in five-gallon jars. [R. 77.]

Herberger bought for cash, not on credit, the cucumbers and other materials and supplies used in his business. [R. 107.] He sold for cash and not on credit. If an invoice was not paid on delivery he kept it in his pocket for a few days until he could collect. [R. 77.]

The method regularly employed in keeping Herberger's books was the cash receipts and disbursements method. His income tax returns and those of his wife, petitioner Mabel Herberger, were made on a cash basis. [R. 107.] He took an inventory at the end of each year. [R. 81.]

On October 31, 1944, one Henry Harmel offered to purchase Herberger's entire inventory of pickles, 1626 barrels, then in the vats at Herberger's processing plant, provided he, Harmel, could have the use of the plant for processing them. [R. 78-79.] An agreement was reached. Herberger turned over to Harmel the keys to the plant and Harmel and his employees processed the pickles there without Herberger's assistance or presence. It was agreed that Harmel should be out by June, 1945, as Herberger expected to buy a new crop in July. Harmel finished the processing in April, 1945. [R. 79.]

The total consideration to be paid by Harmel was $29,-268, computed at $18 per barrel. [R. 79.] The understanding was that pickles would be removed by Harmel from the vats only in proportion to the payments made by him. [R. 61, 65, 83.] He abided by this understanding. [R. 65.] He paid Herberger $10,000 at the time of the agreement, October 31, 1944. He made payments

totaling $14,390 in 1945. As to the balance of $4,878, although petitioners do not concede that this is supported by the record, the Tax Court found that it was paid in 1944. [R. 79.] Herberger took an inventory at the close of 1944, counting as his pickles the proportion not covered by the initial payment of $10,000 in 1944. [R. 83.]

The Commissioner in arriving at the deficiencies which he asserted:

(1) treated this deal with Harmel as an immediate sale, on credit, of the entire stock of pickles in 1944; and

(2) included the deal in its entirety in petitioners' 1944 income on the ground that, by virtue of specified Treasury regulations, petitioners' income was not clearly reflected on a cash basis.

It is these two actions of the Commissioner which present the two issues raised here. The Tax Court sustained the Commissioner on both. The court below affirmed. It is obvious that if the Tax Court was wrong on either issue, there is no need to decide the other.

Specification of Errors to Be Urged.

Petitioners specify the following errors of the Court of Appeals for the Ninth Circuit:

1. Failure to hold that the transaction with Harmel in 1944 was one in which, as each payment was made, there was a sale for cash of an equivalent quantity of the pickles at the price agreed upon.

2. Holding, solely on the basis of certain Treasury regulations, that petitioners' income was not clearly reflected on a cash basis.

REASONS FOR GRANTING THE WRIT.

I.

The Decision of the Court Below Upholding the Tax Court's Conclusion That the Deal With Harmel in 1944 Was an Immediate Sale, on Credit, of Herberger's Entire Stock of Pickles, Is in Conflict With the Settled Law of California, the State in Which the Contract Was Made and Carried Out.

The question whether or not the deal with Harmel in 1944 was an immediate sale, on credit, of Herberger's entire stock of pickles—involving, as it does, the respective rights of the parties in the goods and against each other which ensued from the transaction—is a question governed by local law.

Poe v. Seaborn, 282 U. S. 101, 110;

Freuler v. Helvering, 291 U. S. 35, 45;

Blair v. Commissioner, 300 U. S. 5, 9-10.

When the agreement with Harmel was made, in 1944, the pickels remained in Herberger's vats. Harmel could take them out only as he paid Herberger for them. Herberger took an inventory at the close of the year, counting as his the pickles not paid for, thereby treating the transaction not as a sale on credit, but as one in which, as each payment was made, there was a sale for cash of an equivalent quantity of the pickles at the price agreed upon.

The Tax Court here contended, however (1) that possession of the pickles was transferred to Harmel at the time the agreement was made, and (2) that therefore title passed to Harmel at that time. The court explained the fact that Harmel could not take the pickles out of the vats in advance of having paid Herberger for them by saying

that what Herberger retained in respect to the pickles not paid for was a vendor's lien. [R. 83.] That theory, however, defeats the Tax Court's own conclusion. *A vendor's lien depends upon the continuance of possession by the vendor.* The California Civil Code, Section 1776, provides:

"(1) The unpaid seller of goods loses his lien thereon:

* * * * * * * *

"(b) When the buyer or his agent lawfully obtains possession of the goods;".

In *Hougham v. Rowland,* 33 Cal. App. 2d 11, 90 P. 2d 860 (1939), the court discussed the law of vendor's liens, and said (p. 15):

> "In the above-cited case (*Eads v. Kessler,* 121 Cal. 244, 53 P. 656) the Court quotes section 119 of Tiedman on Sales, as follows: 'In order that a vendor of goods may claim a lien on the goods, they must have already become the property of the vendee, for one cannot have a lien on goods belonging to himself . . . The only cases in which the vendor can have a lien on the goods are those in which the title to the goods passes to the vendee without delivery or *possession.*'" (Italics added.)

It follows that if Harmel did have possession, then Herberger had no vendor's lien. But if Herberger had no vendor's lien, his rights in respect to the goods not paid for could only be explained as ownership. On the other hand, if Harmel did not have possession, the sole basis of the Tax Court's conclusion that title passed to him when the agreement was made disappears. It must follow that Herberger remained the owner of the goods not paid for.

It must follow also that Herberger correctly treated the transaction not as a sale on credit but as one in which, as each payment was made, there was a sale for cash of an equivalent quantity of pickles at the price agreed upon. (Williston on Sales, Revised Edition, Sec. 466a; 22 Cal. Jur. 920, citing *Helms v. Pacific Mill & Timber Co.*, 57 Cal. App. 442, 207 Pac. 708; *Veerkamp v. Hayward C. & D. Co.*, 58 Cal. 229, 41 Am. Rep. 265; *United Canneries Co. v. Seeyle*, 48 Cal. App. 747, 192 Pac. 341.) The decision of the court below in upholding the Tax Court's conclusion that the deal with Harmel in 1944 was an immediate sale, on credit, of Herberger's entire stock of pickles, is in clear conflict with the settled law of California, the state in which the contract was made and carried out.

II.

The Decision of the Court Below That, by Virtue Alone of Certain Treasury Regulations, the Income of Petitioners Was Not Clearly Reflected on a Cash Basis, Is Directly Contrary to Decisions of Courts of Appeals of Other Circuits.

The Internal Revenue Code provides, in Section 41, that the net income "shall be computed . . . in accordance with the method of accounting regularly employed in keeping the books." Only "if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income," may any other method be used. (*Infra*, Appendix, p. 1.) The petitioners here regularly kept their books in accordance with the cash method. The cash method was therefore *mandatory* for them, unless it appears that by the cash method their income was not clearly reflected. The precise question presented therefore

is whether the cash method did or did not clearly reflect petitioners' income.

The reasons given by the court below in answering that question in the negative may be summarized in syllogistic form as follows:

(1) In every case in which the production, purchase or sale of merchandise is an income-producing factor, it is provided under Treasury Regulations 111, Secs. 29.22(c)-1 and 29.41-3(1),[1] that inventories at the beginning and end of each year are necessary in order correctly to reflect the income.

(2) Where inventories are necessary, it is provided under Treasury Regulations 111, Sec. 29.41-2,[2] that no method of accounting will correctly reflect income except an accrual method.

(3) Therefore, in every case in which the production, purchase or sale of merchandise is an income-producing factor, no method of accounting will correctly reflect income except an accrual method.

(4) In petitioners' business, the purchase and sale of merchandise were income-producing factors.

(5) Therefore, in petitioners' business no method of accounting will clearly[3] reflect the income except an accrual method. [R. 109-110.]

There is no contention by the court below, nor by the Tax Court, that the cash basis did not, in fact, clearly

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[1]For the text of these regulations see *infra*, Appendix, pp. 1 and 2.

[2]For the text of this regulation, see *infra*, Appendix, p. 2.

[3]The statute uses the word "clearly" only. The regulations use the word "clearly," and appear also to use the word "correctly" to mean the same thing.

reflect petitioners' income. Nor did the Tax Court find that the Commissioner had so determined. Nor could the Commissioner have so determined. Whether the transaction with Harmel is treated as an immediate sale, on credit, of the entire stock of pickles, or, as Herberger treated it, as a sale for cash, as each payment was made, of an equivalent quantity of the pickles at the price agreed upon, in either case the profit is precisely accounted for.[4] It is on the Treasury regulations alone that the conclusions below were based.

The regulations involved are not of recent origin. They go back, in fact, to the Revenue Act of 1918. Regulations 45, Art. 1581, as amended by T. D. 3286, I-1 C. B. 40 (1922); Regulations 45, Art. 23(1), as amended by T. D. 2873, 1 C. B. 58 (1919). It is remarkable, however, that in all that time, prior to the present proceeding, a matter of approximately thirty years, there was not a single ruling or decision applying these regulations. The only decisions relating to the precise problem were directly contrary to the regulations.

In *Mann v. Commissioner* (App., D. C.), 35 F. 2d 873 (1929), affirming 8 B. T. A. 221, the taxpayer was, *inter alia*, in the merchandising business. He kept his books on a cash basis and filed his returns on that basis. He took inventories at the beginning and end of each year and used them in computing his profit. Before the Board of Tax Appeals he sought an allowance on an accrual basis for certain deduction items not paid during the taxable

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[4]In a substantial sense only the cash basis could clearly reflect the income here; for the use of Herberger's plant by Harmel was an essential element of the transaction, and that use extended throughout the period of payments.

year. The Board denied the allowance because his books were kept on a cash basis. The Court of Appeals for the District of Columbia affirmed.

In *Glenn v. Kentucky Color and Chemical Company, Inc.* (C. A. 6), 186 F. 2d 975 (1951), the taxpayer, a manufacturer, kept its books and made its returns on a cash basis. It took inventories at the beginning and end of each year and used them in computing its profit. The government contended that the taxpayer's income should be recomputed on an accrual basis. The Court of Appeals for the Sixth Circuit rejected the government's contention. It directly considered the regulations here involved and held (a) that they were not mandatory, and (b) that if they were mandatory there would be serious doubt of their validity.

It is helpful to note that the two cases outlined above were not both decisions in favor of the taxpayer. While in the *Glenn* case it was the taxpayer which contended for the cash basis, the basis on which the books were kept, in the *Mann* case it was the government which contended for that basis and was similarly sustained.

It is also helpful to note that the Treasury regulations involved here, which were in effect discredited in the *Mann* and *Glenn* cases, *supra,* are inconsistent with other Treasury regulations. In Regulations 105, sec. 29.22(a)-7, it is provided that a farmer producing and selling "livestock and produce," or buying and selling "livestock or other items," need not take inventories and may report his income on a cash basis. (*Infra,* Appendix, p. 1.) That

provision, too, has been in the regulations since the Revenue Act of 1918. (Reg. 45, Art. 38.) Apparently, then, the regulations which the court below has applied here, under which, "in order to reflect the net income correctly," inventories, and because of inventories the accrual method, are necessary "in *every* case in which the production, purchase or sale of merchandise is an income-producing factor," do not apply to farmers. Yet there is nothing in the statute which exempts farmers from using such method of accounting as clearly reflects their income. The farmer as well as the picklemaker must clearly reflect his income. The regulations as a result are definitely inconsistent.

The court below made no attempt to distinguish the *Mann* and *Glenn* cases. It, indeed, recognized the likelihood that those cases were in conflict with its decision herein; for it stated that "if and to the extent" the *Mann* and *Glenn* cases supported petitioners' contention, it regarded them as erroneous and declined to follow them.[5] [R. 111.] As the analysis of those two cases above shows, the decision below is in clear and direct conflict with them.

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[5]The third case mentioned in the opinion below, *Beckman v. Commissioner*, 8 B. T. A. 830 (1927), while only a Board of Tax Appeals case, is noteworthy in the fact that, as in the *Mann* case, it was the government which contended for the cash basis and was sustained. In the *Beckman* case, the Board, in support of the government, flatly stated: "The fact that inventories were taken at the beginning and close of each year is not sufficient in itself to show that the cash receipts and disbursements method did not clearly reflect income."

III.

The Decision of the Court Below in Basing a Determination as to Accounting Method on a Single Transaction Is in Conflict With Decisions of This Court.

The Tax Court made it clear that nothing was involved here except the deal made with Harmel in 1944. As to the few small invoices which Herberger carried in his pocket for a day or two before he collected them, the Tax Court expressly conceded that there was "no very material difference in the result, tax-wise." [R. 82.] In view of that fact it is not understandable why the court below referred again and again to the amounts of these small items—totaling $171.40 at the end of 1942, and $946.86 at the end of 1943—as if they were on a par with the amount involved in the deal with Harmel.[6] Clearly, it is only the deal with Harmel which is involved here.

A taxpayer's accounting method, however, cannot be predicated on a single transaction. If, disregarding a single transaction, the books clearly reflect the income, the single transaction must be adjusted to the method by which the books are kept and not *vice versa.* (*Security Flour Mills Co. v. Commissioner,* 321 U. S. 281, 285.)

The decision of the court below in basing a determination as to accounting method on a single transaction is thus in conflict with decisions of this court.

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[6]The court below was in error in stating [R. 109] that petitioners made any contention, one way or the other, in regard to the two amounts of $171.40 and $946.86 referred to above. As a quick computation from the record will show, adjusting those two amounts alone to an accrual basis would have meant a slight reduction in tax.

IV.

The Decision of the Court Below Should Be Reviewed Here Because of Its Importance; More Than 200,000 Taxpayers Are in Precisely the Same Position as Petitioners Here, and Will Be Affected in the Same Manner by the Result in This Proceeding.

The only available statistics as to the number of taxpayers using particular accounting methods in specified industries are those published by respondent under the title "Statistics of Income." The latest figures so reported are for 1946. In Part 2, pages 15-16, of the issue for that year it is shown that of corporations engaged in manufacturing and trade, excluding those operating on a commission basis, 33,169, or approximately 13 per cent of the total, made their returns according to the cash method. Most of these corporations were, indeed, small corporations, as the figures on page 17 of the same issue indirectly indicate.

There are no similar published data on partnerships and individuals. However, there are more than a million and half individuals engaged in manufacturing and trade. "Statistics of Income," 1945, Part 1, page 194. Obviously they are smaller than corporations and should therefore contain a higher percentage of taxpayers on a cash basis. But if only the same percentage were on a cash basis, that would be over 195,000. We suggest the likelihood that respondent has and could submit the precise figure.

Clear it is, in any event, that more than 200,000 taxpayers, not counting farmers, are engaged in a business in

which "the production, purchase, or sale of merchandise is an income-producing factor," but keep their books and make their returns on a cash basis. More than 200,000 taxpayers are therefore in precisely the same position as petitioners here and will be affected in the same manner by the result in this proceeding. For that reason alone, we submit, the decision of the court below should be reviewed by this court.

Conclusion.

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

GEORGE T. ALTMAN,
Attorney for Petitioners.

APPENDIX.

Statutes and Regulations Involved.

. . . . . .

INTERNAL REVENUE CODE.

"SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income . . ."

REGULATIONS 111.
Relating to the Income Tax.

. . . . . .

"Sec. 29.22(a)-7. Gross income of farmers.—A farmer reporting on the basis of receipts and disbursements (in which no inventory to determine profits is used) shall include in his gross income for the taxable year (1) the amount of cash or the value of merchandise or other property received during the taxable year from the sale of live stock and produce which were raised during the taxable year or prior years; (2) the profits from the sale of any live stock or other items which were purchased, and (3) gross income from all other sources. . . ."

. . . . . .

"Sec. 29.22(c)-1. Need of inventories.—In order to reflect the net income correctly, inventories at the beginning and end of each taxable year are necessary in

every case in which the production, purchase, or sale of merchandise is an income-producing factor. . . ."

. . . . . .

"Sec. 29.41-2. Bases of computation and changes in accounting methods.—Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. . . . All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. . . . For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. . . ."

. . . . . .

"Sec. 29.41-3. Methods of accounting.—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. . . .

"(1) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, inventories of the merchandise on hand (including finished goods, work in process, raw materials, and supplies) should be taken at the beginning and end of the year and used in computing the net income of the year. . . ."

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In the Supreme Court of the United States

OCTOBER TERM, 1952

No. 94

GEORGE HERBERGER AND MABEL HERBERGER,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Court of Appeals for the Ninth Circuit (R. 106-111) is reported at 195 F. 2d 293. The memorandum findings of fact and opinion of the Tax Court (R. 74-88) are not reported.

JURISDICTION

The judgment of the Court of Appeals (R. 112) was entered March 7, 1952. The petition for a writ of certiorari was filed May 31, 1952. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTIONS PRESENTED

1. Whether the facts set out in the Tax Court's findings evidence a completed sale in 1944 of the taxpayer's remaining stock of pickles in process, as held by the courts below.

2. Whether the courts below erred in holding that the taxpayers' income was properly computed by the Commissioner on an accrual basis.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the Internal Revenue Code and Treasury Regulations are set forth in the Appendix, *infra,* pp. 10-13.

STATEMENT

So far as material to this petition for a writ of certiorari, the Commissioner of Internal Revenue determined deficiencies (along with deficiencies and penalties for 1942 and 1943 not here in controversy) in federal income taxes for 1944 against George Herberger (herein sometimes referred to as the taxpayer) and his wife, Mabel (residents of California who filed their returns on a community property basis), aggregating $6,048.16, to which he added fraud penalties aggregating $3,024.08. (R. 75-76.) The Tax Court redetermined a deficiency of $2,011.34 against George Herberger for that year and a fraud penalty of $1,479.30; and redetermined a deficiency of $2,068.96 against Mrs. Herberger, but eliminated the fraud penalty. (R. 89, 90.) The Court of Appeals for the Ninth Circuit affirmed the Tax Court's decisions. (R. 112.)

The material facts may be summarized as follows:

During 1944 and for many years prior thereto, the taxpayer was engaged in the business of processing and selling pickles. He bought his year's supply of cucumbers in July each year. The curing in salt required 90 to 120 days. Thereafter quantities of the pickles were placed in smaller vats and processed for about three days. He could process a total of 42 barrels a week. He sold his pickles in barrels or in five gallon jars. (R. 77.) Thus a large portion of the pickles purchased and processed in one year necessarily would be sold during the following year in the ordinary course of taxpayer's business.

The taxpayer bought for cash, not on credit, the cucumbers and other materials and supplies used in the business. He usually sold for cash, not on credit, the pickles processed. Occasionally, however, pickles sold in one year were paid for in the next. (R. 107.)

The method of accounting regularly employed by the taxpayer in keeping his books was the cash receipts and disbursements method. The income tax returns of the taxpayer and his wife stated that they were prepared on a cash basis. (R. 76, 84, 107.)

The taxpayer took an inventory of his pickles at the end of each year and the inventory figures were used in his returns in computing the cost of goods sold. (R. 82, 109-110.)

On October 31, 1944, Henry Harmel, one of the taxpayer's customers, offered to purchase the taxpayer's entire available stock, then in vats at the plant. An agreement was reached for the sale at an invoice price of $15 per barrel plus a side payment of $3 per barrel. Harmel paid the taxpayer $10,000 in cash on that date and the taxpayer gave him an invoice which, in addition to acknowledging receipt of the payment of $10,000 on account, recited that taxpayer had "sold" to Harmel 1,626 barrels of "field run salt stock" at $15 per barrel, including use of cooperage and also use of his plant, the purchaser to pay for the light, water, gas, and telephone. The taxpayer turned over to Harmel the keys to the processing plant and Harmel and his employees processed the pickles there without the taxpayer's assistance or presence. The understanding was that Harmel should have the use of the plant to process the 1,626 barrels, but should be out by June, 1945, as the taxpayer expected to buy a new crop in July. Harmel finished the processing in April, 1945. (R. 78-79.)

Harmel paid to the taxpayer the over-ceiling consideration of $4,878 in 1944, and paid to him the $14,390 balance of the purchase price in 1945. (R. 79.)

The Commissioner, the Tax Court, and the Court of Appeals held that under these facts the income of the taxpayer and his wife from the pickle business must be computed on an accrual basis, and that the $14,390 received by the taxpayer from Har-

mel in 1945 should be included in their taxable income for 1944. (R. 76, 81-84, 106.)

ARGUMENT

At the outset, it should be observed that this case is an isolated one in which the income involved was derived entirely from a stock of pickles purchased in the ordinary course of business by taxpayer, but wholly disposed of by him in a single transaction. The precise question presented is which accounting method, the cash receipts and disbursement basis or the accrual basis, reflects true income during the year involved. It is patent, therefore, that the question presented turns on the peculiar facts of the case, and that in any event the situation is unique and not likely to arise with such frequency as to call for review of the case by this Court.

1. The decision below is not, as contended by petitioners (Pet. 5, 7), in conflict with the settled law of California. This contention of petitioners is based on a misunderstanding of the Tax Court's statement with respect to a vendor's lien. The Tax Court merely said that the understanding of the parties that payments would be made to cover the quantity of pickles removed at any time "is consistent" with the theory that Herberger retained a vendor's lien on the pickles to secure payment of the balance (R. 83). The Tax Court did not state, as petitioners seem to think (Pet. 6), that Herberger retained a vendor's lien, and its statement was not, as petitioners contend (Pet. 6), the

"sole basis" of its conclusion that title passed to the purchaser when the agreement was made. The evidence fully supports the statement in the Tax Court's opinion (R. 83) that Herberger "did all that was necessary to put the buyer into possession." Petitioners seem to take the erroneous position that the seller must either have a vendor's lien or a retained ownership until the purchase price is paid. But this is not necessarily so. If the agreement with Harmel constituted a completed sale by Herberger of his remaining stock of 1626 barrels on October 31, 1944, which we submit it was, the question whether he had a vendor's lien under California law for the unpaid balance is not of controlling importance. If he did not have a vendor's lien under the circumstances, which is debatable, he at least had a chose in action against the purchaser for the unpaid balance of the purchase price.

To support the contention that pickles were sold only as cash payments were made by the purchaser, it is stated by petitioners (Pet. 5), but not found by the Tax Court, that "Harmel could take them out only as he paid Herberger for them." But Harmel paid $10,000 cash upon consummation of the agreement on October 31, 1944, and paid the over-ceiling consideration of $4,878 in 1944, all without taking out any of the pickles in process. This is wholly inconsistent with the idea that the pickles were sold on a cash basis and that sales were consummated only as payments were received.

2. Petitioners' contention (Pet. 7-11) that the Tax Court and the court below erred in holding

that no method of accounting in regard to purchases and sales, other than the accrual method, would reflect the true income of taxpayer's pickle business for the year 1944, is without merit. In concluding that only the accrual method of accounting would reflect the true income of that business, the courts below applied the principle embodied in Section 29.41-2 of Treasury Regulation 111, *infra*, pp. 11-12, which, by way of illustration in connection with Section 41 of the Internal Revenue Code, *infra*, pp. 10-11, states:

> For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method * * *.[1]

Petitioners rely on *Mann* v. *Commissioner*, 35 F. 2d 873 (C.A.D.C.) and *Glenn* v. *Kentucky Color & Chemical Co.*, 186 F. 2d 975 (C.A. 6) as holding that the cash receipts and disbursement method of accounting will reflect true income in cases where inventories are used to show costs of

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[1] The provisions of the Treasury Regulations governing inventories by taxpayers are contained in Section 29.22(c)-1 of Treasury Regulations 111, *infra*, p. 11, providing (pursuant to Section 22(c) of the Internal Revenue Code, *infra*, p. 10), that in order to reflect the net income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor; in Section 29.41-3(1) of Regulations 111, *infra*, pp. 12-13, providing (pursuant to Section 41 of the Code, *infra* pp. 10-11), that in all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, inventories of the merchandise on hand (including finished goods, work in process, raw materials, and supplies) should be taken at the beginning and end of the year and used in computing the net income of the year.

sales and then assert that those cases are in conflict with the decision of the court below. As the court below stated (R. 111), those cases differ materially from the case at bar. In both of those cases the income of the taxpayers was derived from various sources. In the *Glenn* case the courts held that the cash receipts and disbursement method fairly and honestly reflected true income with only minor deviations from the cash receipts and disbursements basis. And in the *Mann* case, the court observed that the greater part of taxpayer's business transactions was accounted for on the cash receipts and disbursement basis. Thus, each of those cases was decided on its own peculiar facts, and those facts were materially different from the facts in the case at bar where the income was derived solely from a source which required the use of inventories to determine the cost of the goods sold. Hence, the *Glenn* and *Mann* cases are not in conflict with the decision of the court below.

Nor is the decision of the court below in conflict with the decision of this Court in *Security Mills Co.* v. *Commissioner,* 321 U.S. 281 (Pet. 12). In the *Security Mills Co.* case, this Court held merely that the Commissioner may not isolate a single transaction and treat it differently from the remainder of the taxpayer's business. Manifestly, the situation in the *Security Mills Co.* case was different from the instant case where the single transaction was the entire business for the year, except one or two minor invoices which made no material difference in the tax result.

In the case at bar, the entire income was ascertained by the use of inventories, and it is plain that cash receipts and disbursements could play no part in determining the amount of that income, since it was dependent not upon cash received or spent, but upon the difference between cost and the sales prices, less expenses, of the goods moved. See *Lucas* v. *Structural Steel Co.*, 281 U.S. 264, 268-269, where this Court pointed out that the federal income tax system is based upon annual accounting periods, which requires that gains or losses be accounted for in the year in which they are realized, and that the purpose of inventories is to assign to each period its profits and losses. Here, petitioners have not demonstrated that the cash receipts and disbursement method of accounting clearly and honestly reflected their income.

CONCLUSION

The decision of the court below is clearly correct and further review is not warranted. The petition for a writ of certiorari should, therefore, be denied.

Respectfully submitted,

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JULY, 1952.

APPENDIX

Internal Revenue Code:

SEC. 22. GROSS INCOME.

* * * * *

(c) *Inventories.*—Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

* * * * *

(26 U.S.C. 1946 ed., Sec. 22.)

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has

no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

For use of inventories, see section 22(c).

(26 U.S.C. 1946 ed., Sec. 41.)

SEC. 42 [As amended by Sec. 114, Revenue Act of 1941, c. 412, 55 Stat. 687] PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

(26 U.S.C. 1946 ed., Sec. 42.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.22(c)-1. *Need of Inventories.*—In order to reflect the net income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. * * *

* * * * *

SEC. 29.41-2. *Bases of Computation and Changes in Accounting Methods.*—Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless

all items of gross income and all deductions are treated with reasonable consistence. See section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. (See sections 29.42-2 and 29.42-3.) On the other hand, appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property. (But see section 29.22(c)-5.).

* * * * *

SEC. 29.41-3. *Methods of Accounting.*—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records

as will enable him to do so. (See section 54 and section 29.54-1.) Among the essentials are the following:

(1) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, inventories of the merchandise on hand (including finished goods, work in process, raw materials, and supplies) should be taken at the beginning and end of the year and used in computing the net income of the year (see section 22(c) and sections 29.22(c)-1 to 29.22(c)-8, inclusive) * * *.

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Cases	Page
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IN THE

Supreme Court of the United States

October Term, 1952
No. 94

GEORGE HERBERGER and MABEL HERBERGER,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

PETITIONERS' REPLY BRIEF.

I.

Respondent on page 8 of his brief attempts to distinguish the case at bar from *Mann v. Commissioner,* 35 F. 2d 873 (C. A. D. C.), and *Glenn v. Kentucky Color & Chemical Co.,* 186 F. 2d 975 (C. A. 6), as follows:

> "Thus, each of those cases was decided on its own peculiar facts, and those facts were materially different from the facts in the case at bar where the income was derived solely from a source which required the use of inventories to determine the cost of the goods sold."

What respondent is saying, in other words, is that in the *Glenn* and *Mann* cases only a part of the income came from a source requiring the use of inventories whereas in the case at bar the income was derived entirely from such a source.

The regulation on which respondent relies here, however (Br. p. 7), recognizes no such distinction. Moreover, as far as the *Glenn* case is concerned, even that distinction has no actual existence. There is not a word in the opinion in that case indicating that the taxpayer there was engaged in any business other than one requiring the use of inventories.

II.

Respondent also on page 8 of his brief attempts to distinguish *Security Mills Co. v. Commissioner,* 321 U. S. 281, as follows:

> "Manifestly, the situation in the *Security Mills Co.* case was different from the instant case where the single transaction was the entire business for the year, except one or two minor invoices which made no material difference in the tax result."

The quoted statement is plainly untrue. As shown by the findings and opinion of the Tax Court herein, petitioners' returns for 1944 showed receipts totaling $28,472.20, and of that amount only $10,000 was derived from the single transaction here involved. [R. 81.] Moreover, all of the receipts except the said amount of $10,000 were receipts in the normal course of Herberger's business, receipts on sales of processed pickles in barrels or in five-gallon jars [R. 77]; whereas the said $10,000 was derived from a transaction wholely outside of the normal

course of his business, a transaction under which he contracted to sell to one purchaser his entire stock of pickles, unprocessed, and in addition gave the purchaser the use of his plant for a period of more than six months. Respondent's sole basis for distinction of the *Security Mills Co.* case is thus wholely without foundation.

III.

Respondent states on page 5 of his brief that the issue here is a matter of slight importance. As shown, however, in petitioners' opening brief, pages 13-14, more than 200,000 taxpayers are, in respect to the issue here involved, in precisely the same position as petitioners. This fact respondent makes no attempt to answer.

Conclusion.

Petitioners submit that, for the reasons stated herein and in petitioners' opening brief, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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Attorney for Petitioners.